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AZ CORP COMMISSION**TO:** Ray Williamson, Acting Director, Utilities Division, Arizona Corporation Commission

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FROM: Rick Gilliam, Land and Water Fund of the Rockies

DOCUMENT CONTROL

SUBJECT: COMMENTS OF THE LAND AND WATER FUND OF THE ROCKIES
REGARDING THE ACC STAFF RESTRUCTURING PROPOSALS AND THE
PROPOSAL OF ARIZONA PUBLIC SERVICE

The Land and Water Fund of the Rockies (LAW Fund) submits its comments on the proposed modifications to the Commission's Restructuring Rule of the Staff and of Arizona Public Service Company. To a large extent, the LAW Fund's concerns with electric utility restructuring relate to market power issues, appropriate mechanisms for the continued protection of public interests developed within a regulated environment, and development of new clean electricity resources in the upcoming competitive structure.

ACC Staff Proposals

We applaud the Staff for its boldness in addressing the complex and very difficult issues in a balanced way. Market power concerns are the dominant theme of our comments regarding stranded costs and affiliate rules.

We support the Staff's proposal for recovery of stranded costs. We believe that this approach would likely provide the most accurate market value and best market power result. We also agree that the divestiture option should be 100% of non-nuclear production assets including purchased power contracts. We do not oppose competitive energy supply subsidiaries of the incumbent utilities bidding to acquire any or all of these assets.

We strongly support very tight affiliate rules. Indeed, we are concerned that even corporate separation, i.e. segregated accounting, financial statements, operations, etc., will be insufficient to avoid strategic use of regulated assets to create advantages for competitive businesses within the same holding company. The ACC (and Attorney General) should examine these affiliate issues very closely, and leave open the possibility of requiring a spin-off of competitive businesses from regulated.

Arizona Corporation Commission
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Arizona Public Service Company (APS) Proposal

A significant portion of the APS proposal addresses non-discriminatory **transmission access** and the issues surrounding development of an Independent System Operator (ISO) or Independent System Administrator (ISA) including pricing, operating, planning, and so forth. We agree that these difficult issues need to be addressed in a way that is fair to suppliers, customers, and public interests alike. Many of these interests have been participating in the Desert STAR ISO/ISA development process for the past 12 months with mixed success. Indeed, a similar ISO considerably further along in its development, IndeGO, was recently abandoned as a result of the high cost of implementation and concerns about cost-shifting among members.

We very much agree with APS that development of a system of non-discriminatory transmission access for all competitors and customers is critical to a fair competitive market structure. Indeed, the LAW Fund has been working on a variation of the ISO concept that may address some of the more difficult financial issues. A copy of our comments to the FERC that discuss this proposal is included as Attachment A.

With respect to a **rate reduction mechanism**, the APS proposal suggests that a performance-based mechanism be developed which provides an opportunity for reductions. While we generally support performance-based rate mechanisms, it hardly seems worth the considerable development effort given that such mechanism would only be in place for two years. A straightforward rate reduction for customers not participating in the competitive market would be more appropriate under these circumstances. However, to the extent that current rates form the basis for standard-offer tariffs potentially effective for up to 10 years, incentives to increase supplier efficiency would be appropriate.

The **System Benefits Charge (SBC)** is a key issue for public interest advocates, representing the means by which important public interest programs, developed in a highly regulated environment, can continue in a lesser regulated one. The APS proposal indicates various funding levels the SBC components, which it terms "appropriate." Other than the two nuclear items, the total amount is \$10.7 million – about the level that the Company is authorized to spend on demand-side management (DSM) and renewables alone.

DSM is a very cost-effective resource. While DSM programs may not add to the short-term profitability of the utility, its many benefits include risk diversification, localized transmission and distribution savings, targeted peak reductions, and reduced bills for customers.

The benefits of DSM tend to favor residential and small commercial customers. As competition is introduced into the Arizona energy market, large customers, with their strong buying power, are likely to capture the best energy supply deals on the market. Indeed, both the ACC Staff proposal and the APS proposal give large customers the earliest access to competitive energy suppliers.

DSM may turn out to be the major benefit of competition provided to small customers, but the funding levels proposed by APS as "appropriate" are very low. We believe the proper amount of DSM and associated funding can be estimated by examining the DSM amounts the utilities found to be cost-effective in "pre-competition" Arizona.

In pre-competition Arizona, utilities were interested in developing programs that provided long-term benefit to consumers, with lesser emphasis on short-term earnings. For example, APS testified in the 1993 IRP that over the next ten years, its resources were planned to increase by 888 MW. Of this amount, approximately 518 MW would be met through DSM programs. The cost of DSM has been coming down, but even at a cost of \$250 - \$300/kW (approximate 1993 average DSM costs), 52 MW of DSM per year would have cost about \$15 million. The rate settlement in 1994 established a budget of \$14-18 million for DSM and renewables. With about \$3 million earmarked at that time for renewables, the range for DSM is \$11 - \$15 million per year. As the threat of competition became more real, these amounts were slashed to a minimum of \$7 million, with authorization up to \$10 million for energy efficiency and renewables in the 1996 APS rate case settlement.

A recent example of DSM costs and benefits is the result of a \$5 million DSM bid let by Public Service Company of Colorado (now New Century Energies, or NCE). The utility signed contracts for 30 MW of DSM at an average cost of \$162/kW. This compares to a capital cost of \$800 to \$1,500 per kW for traditional supply-side resources (excluding nuclear). While the majority of these bids related to energy efficiency programs for commercial customers, all customers of NCE will benefit through the utility's ability to meet a portion of its growing needs at an extremely low cost.

In regards to *renewables*, it will be difficult, if not impossible, for APS to achieve its renewable resource goals identified in the last IRP at the proposed funding levels. At the very least, sufficient funding, as provided in the rule, must be required. The Commission addressed funding for renewables in the 1993 IRP. During the hearings in Docket No. 93-052, APS indicated that it is willing to strive toward a "goal" of 12 MW for renewables by 2000. The Commission in its order in this matter responded as follows:

"We [the Commission] regard these statements as serious commitments and will accept them as planning goals. However, if APS and TEP appear to fall significantly short of meeting these goals, we shall reconsider short-term set asides."

Further perspective may be gained through comparison with the nuclear elements of the SBC. While APS has been collecting about \$11 million/year through rates to fund decommissioning of Palo Verde, it seeks to increase this amount by over 10% in its SBC proposal. This was not unexpected. Experience at other utilities has indicated that these costs tend to go up rather than down. Clearly, APS views its nuclear decommissioning program as underfunded at current rate levels. If funding is inadequate to achieve program goals, clearly the funding level must be increased. Similarly, renewables programs should be fully funded to meet program goals

Another point of reference is the SBC rate developed in other states. In recognition of the benefits of these programs developed under a regulatory regime, regulatory bodies around the country have developed, or are developing, mechanisms like the SBC to assure that they continue to be funded.

State	SBC Rate (mills/kWh)
California	3.0
Connecticut	5.5
Illinois	7.0
Maine	1.0
Massachusetts	2.0
Montana	1.1
New Hampshire	1.5
New York	9.9
Rhode Island	2.2
Vermont	4.5
Wisconsin	1.6
Average	3.1

In contrast to these figures, the non-nuclear portion of APS System Benefits Charge proposal is about 0.6 mills per kWh, or about 60¢/month for the average residential customer. The nuclear portion represents about a dollar/month for each residential customer. As APS whittles down the dollars it invests in DSM, renewables, and low-income programs over the years, it proposes to increase the nuclear decommissioning costs from \$11 to \$12.2 million, or about 10%.

We believe that \$11 to \$15 million for DSM plus the appropriate dollar amount for APS to reach 12 MW of renewable resources is justifiable. In the interest of compromise however, we believe the DSM and renewables portion should at least be equal to the pre-competition amounts of \$18 million – about the same as the current nuclear costs. Combined with \$4.2 million for low-income rate discounts and other low-income programs, the total SBC should be \$40.4 million, or about \$2.25 per average residential customer.

On page 8 of the APS proposal, disclosure of the ESP's generation mix is touched upon. This is a very important issue and the burden should not be placed upon the customer to obtain this information. That would be akin to a consumer having to write to Kellogg's to find out the ingredients of its cereals. It's not going to happen.

In March 1997, the public utility commissioners of the six New England states initiated an effort to see whether and how uniform consumer information disclosure for the retail sale of electricity might be developed for use throughout the region. The New England Information Disclosure Project, with the help of a very broad group of stakeholders, developed a report and recommendations to the New England Utility Regulatory Commissions. Their rationale for developing uniform disclosure standards is as follows:

Shopping for electricity is a new experience for consumers. Experience with pilot programs showed a high level of consumer confusion as complex price structures made it difficult to compare competing offers and the intangible nature of the commodity made it nearly impossible for customers to determine the sources of their power or to verify whether sellers' claims were true. Without a common language that provides an accurate, objective basis for comparing claims of competitive suppliers, customers will find it difficult, or in many cases impossible, to compare the price, fuel and emissions characteristics of potential electricity purchases. In fact, in some of the retail choice pilots, misleading claims were common.¹ Customer focus groups conducted with pilot program participants

¹ Some argued that a number of the environmental claims made in the pilots violated existing laws regarding environmental claims used in marketing and that, had the law been adequately enforced, some, or perhaps all, of these abuses would not have occurred. They may be correct in arguing that some of the abuses in the pilots were, in fact, in violation of the current Federal Trade Commission (FTC) guidelines.

However, even if we could assume adequate funding of the FTC's enforcement activities, relying solely on existing law would fall far short of the proposed disclosure in a number

in New Hampshire and Massachusetts confirm that consumers strongly dislike making the "apples to oranges" comparisons with which they have been presented.

Standardized, consumer-friendly labeling and disclosure is required in many sectors of the retail economy such as food, automobiles and consumer credit to correct informational imbalances between seller and buyers and to provide a uniform basis for comparison of material terms. A uniform disclosure mechanism for retail electricity sales will give customers an accurate, objective basis for comparing price and environmental claims of competitive suppliers.

A disclosure policy covering price, fuel mix and emissions will also protect suppliers from unfair trade practice claims by setting clear rules of the road. It protects against customers having difficulty comparing prices and a backlash aimed at environmentally-benign resources by helping to insure that customers get what they want and pay for. Depending on the level of customer demand, it can result in cleaner resources and less pollution.

In addition, the National Association of Regulatory Utility Commissioners (NARUC) passed a resolution in November 1996 calling for uniform disclosure standards including price, price variability, resource mix and the environmental characteristics of electricity purchases.² The resolution concludes that:

The National Association of Regulatory Utility Commissioners (NARUC), ... believes that the electric industry should facilitate informed customer choice that will promote efficient markets, resource diversity, and environmental quality; and

NARUC supports initiatives leading to minimum, enforceable, uniform standards for the form and content of disclosure and labeling that would allow retail and wholesale consumers easily to compare price, price variability,

of respects. There would be no uniform price information; absent some type of environmental claim, there would be no fuel or environmental information at all; and if an environmental claim were made, it would only provide the same information as the disclosure label if the marketer wished to make broad environmental claims regarding both fuel and emissions.

² Disclosure is factual and objective. For example a particular purchase might be 40 percent coal, 30 percent gas and 30 percent geothermal power. It does not address subjective claims, such as whether a particular purchase is good or bad, clean or dirty.

resource mix, and environmental characteristics of their electricity purchases; and

NARUC urges states adopting retail direct access programs to include enforceable standards of disclosure and labeling that would allow retail consumers easily to compare the price, price variability, resource mix, and environmental characteristics of their electricity purchases.

We recommend that as a part of obtaining a certificate under Section R14-2-1603 of the Rule, the Commission require all ESPs to file information related to price, resource mix, and environmental characteristics on a periodic basis (e.g. every three or six months). The Commission can then determine the "average" of these values for the state, which the ESPs would be required to disclose to customers also on a periodic basis and in all marketing materials. Restructuring Rule Section R14-2-1613 (L) has sufficient latitude to require ESPs to disclose such information to customers. That language is as follows:

- L. Electric Service Providers shall provide notification and informational materials to consumers about competition and consumer choices, such as a standardized description of services, as ordered by the Commission.

The APS proposal suggests that the **Integrated Planning Rules (IRP)** serve no useful purpose and should be replaced, but do not propose a replacement. The IRP Rules are the subject of another docket at the Commission, currently on hold pending the outcome of the Restructuring Rules. The IRP Rules should be addressed in that docket.

Finally, the APS proposal does not address the Solar Portfolio Standard. We take this silence to mean that APS does not oppose the current treatment in the Rule, with which we agree.

ATTACHMENT A**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

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Inquiry Concerning the Commission's)
Policy on Independent System Operators)

Docket No. PL98-5-000

**FERC ISO Conference Comments
A Proposal for a Non-Profit Transco in the West**

The Land and Water Fund of the Rockies (LAW Fund) is a non-profit group that promotes a variety of long-term public interests involving environmental quality, risk diversification, and improved energy efficiency in six western states. As part of this work, we have participated in reviewing and commenting on the (now suspended) Indego proposal. These comments are based on that experience.

In our view, ISO proposals like Indego represent a significant improvement over the status quo as they help limit market power, create more workable pricing regimes, and enhance coordination among stakeholders so as to help maintain short-term system security. Despite these benefits, however, we believe that the formation of a new, non-profit transmission owning entity — call it a "Transco" — can produce substantial incremental economic and public policy benefits in a way that preserves most of the core aspects of ISO proposals like Indego. More specifically, we propose that a new, non-profit Transco be formed in the West to acquire, own, expand, maintain, and operate the interconnected grid. The key difference between Indego and this proposed Transco is that key transmission-related investment and maintenance decisions would now be vested in the Transco, not existing vertically-integrated entities.

The economic benefits of this Transco approach can be significant. In the case of Indego, we calculate that the creation of a new non-profit Transco could reduce Indego's revenue requirement by almost 15% or roughly \$170 million annually — a present value gain of \$1.2 billion over ten years. This gain arises from lower financing and tax costs. The for-profit, investor-owned utilities (IOUs) that signed the original Indego MOU require an average rate of return of just under 13% (including taxes) on their combined transmission-related rate base of \$3.1 billion. In contrast, conversations with banks such as the National Rural Utilities Cooperative Finance Corporation (CFC) indicate that a new non-profit Transco could conservatively finance the acquisition of the IOU transmission assets using a rate of return of 7.5%. Additional gains are possible over time as the Transco could finance new

transmission-related investments at this lower cost. The first-year benefits of this approach for the IOUs that signed the Indego MOU are summarized in Table 1 below.

**Table 1: Economic Benefits
of the Non-Profit Transco Approach**

	Transmission Revenue Requirement	Total IndeGO IOUs	Total New Transco
1	Net Transmission & Related Plant	\$3,445,274,550	\$3,445,274,550
2	Other Rate Base Items	(327,060,137)	(327,060,137)
3	Transmission Rate Base	3,118,214,413	3,118,214,413
4	Operating & Maintenance Expense	\$110,884,685	\$110,884,685
5	Depreciation & Amortization Expense	115,868,151	115,868,151
6	Taxes Other than Income	51,043,059	51,043,059
7	Transmission Expense	277,795,895	277,795,895
8	Facility Related Rev Credits	(11,647,972)	(11,647,972)
9	Subtotal Transmission Expense	266,147,923	266,147,923
10	Return Requirements		
11	Overall Cost of Capital (incl. Income Taxes)	12.95 %	7.50 %
12	Return (and Income Taxes if Required)	403,681,343	233,866,081
13	Revenue Requirements	\$669,829,266	\$500,014,004
14	Revenue Requirement Savings		\$169,815,262
15	Percentage Savings		25 %

In addition to the economic gains, this Transco approach also should be superior from a public policy perspective. Under ISO proposals like Indego, key transmission-related investments involving reliability, environmental quality, risk diversification, and other long-term public interests will be made by market players in response to pricing signals established in the ISO proposal. As retail competition expands, however, today's market players are fundamentally not structured to engage in the type of long-term planning, cooperative practices, and low-risk/low-return "public good" type investments needed to protect long-term public interests like reliability. Instead, most market players now seem to be pursuing investments that produce high returns, create short payback horizons, and provide experience operating in a competitive environment. A new Transco, however, can be set-up — through its articles of incorporation, bylaws, and capital structure — to protect reliability and other long-term public interests.

To state this public policy problem another way, today's vertically integrated utilities appear to be applying the wrong financial criteria to investment decisions involving reliability and other long-term public interests. Utilities currently raise capital based on the assets of the entire company. Since many of the current investments of vertically-integrated utilities — such as overseas acquisitions, domestic mergers, and the creation of unregulated power marketing

subsidiaries — are subject to substantial risk and competitive pressure, this portion of the business, when considered on a stand-alone basis, often requires a cost of equity of 15% or higher. In contrast, the transmission component of the industry (as a stable, regulated, cost-of-service monopoly) is subject to significantly less risk and should thus be able to attract low-cost capital, rely on greater debt leveraging, and amortize capital costs over a longer-time period, up to 50 years. As a result, a discount rate of 6-7% should be used to determine, for example, whether investments in system reliability should be made — well below the effective rate that today's utilities appear to be using. The creation of a non-profit Transco would solve this financial incentive problem.

The impact of this financial incentive can be significant. In the West, O&M budgets for maintaining the transmission system, and capital investments for improving it, have both been sharply reduced. Likewise, utilities concerned primarily with limiting their upfront capital expenditures have proposed siting large new transmission lines by elementary schools, across sacred tribal lands, and through wilderness study areas. Again, we believe that a new Transco with access to low-cost capital and with an appropriate governance structure would be in a far better position to balance the need to limit upfront capital expenditures against society's preference to protect long-term public interests involving system reliability and environmental quality.

A third problem with ISOs surrounds the residual market power of the vertically-integrated utilities. Even if operational and pricing decisions are truly vested in an independent entity, most ISO proposals allow vertically-integrated generation-owning entities to continue to own the transmission assets and to have primary responsibility for key investment decisions. As a result, the risk remains that these companies can gain a competitive advantage for their generation assets through their control over the investment, maintenance, and expansion decisions associated with transmission facilities. The formation of a new Transco would largely eliminate this concern by placing ownership, investment, and maintenance decisions into a new entity. This Transco approach would also help further ensure that operational and pricing decisions were, in fact, made independently.

Fourth, the Transco approach can be implemented in a way that retains most of the core compromises that have been reached by the sponsors of the ISOs. For example, the new Transco could rely on a similar governance structure as the ISO (although we would propose greater public interest representation). Likewise, the pricing, tariff, performance standard, and integration agreements and filings that comprise the core of ISO proposals like Indego could all be directly transferred to a new Transco. Indeed, the primary changes to the current Indego proposal necessary to form a new Transco would be limited primarily to the articles of incorporation and the bylaws.

Finally, it is our current understanding that the efforts to implement ISO proposals like Indego are under considerable pressure as many of the original utility sponsors are not willing to participate in a FERC filing. The reality appears to be that it is difficult to form an ISO across multiple states, with numerous and diverse utilities, and in the absence of a tight power pool. The economic gains associated with the Transco approach as described above — if split

equitably between shareholders and customers — could provide the requisite incentive for at least the investor-owned utilities to participate in a region-wide entity.

There are a number of actions FERC could take to promote the formation of Transcos. For one, FERC could ensure that any IOU selling its transmission assets to a Transco would be entitled to a reasonable acquisition premium. FERC could also help encourage utilities who are merging to divest their transmission assets as part of the approval process. In addition, FERC could ensure that any approved ISO structure could be adapted over time into a Transco. Finally, FERC should monitor the data on key utility transmission-related investment and maintenance decisions to determine whether or not the financial incentives resulting from the potential for expanded retail choice are inappropriately discouraging today's utilities from adequately protecting reliability and other long-term public interests.

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Respectfully Submitted,

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